BALDINI
INVESTMENT STRATEGIES

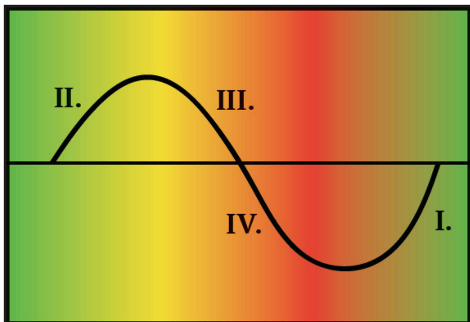
July 2020

Month in Review

The S&P 500 rose 1.8% in June, posting its third straight monthly gain. That's not to say it was smooth sailing. Stocks tumbled 7% mid-month in the worst sell off since March when Federal Reserve Chair Jerome Powell talked down the economy in his remarks following the FOMC meeting. The Fed moved quickly to calm the markets by announcing a new program to buy individual corporate bonds in addition to Exchange Traded Funds (ETFs). With the Fed's foot firmly on the accelerator, not even a record spike in new coronavirus cases could stop the market's forward momentum and the major indices all closed positive for the month. It's time to check our indicators to see how the tug of war between the virus and the Fed has affected them. I have also provided a brief summary of my thoughts on the market going forward.

I. CREDIT CYCLE

PHASE I: EARLY EXPANSION



The credit bull market rolls on as easy money from the Fed allows companies with even the lowest credit ratings to repair their balance sheets. Meanwhile, the Fed's balance sheet has swelled to more than $7 trillion from about $4 trillion in early March and the growth rate in M2 money supply has gone parabolic. The surging liquidity has provided a significant tailwind to both stocks and bonds. The Fed can't print profits, however, and for the cycle to be sustained low interest rates and rising stock prices will need to stimulate demand and lead to higher profits and improving cash flows.

II. RISK LEVEL INDICATORS

US STOCKS: GUARDED

The Risk Level for **US Stocks** has dropped to GUARDED. There is growing evidence that the economy may have hit bottom in May. Recovering lost ground will take time, perhaps years, but it's important to recognize that a key milestone has been passed and the economy is no longer contracting. The short-term SWING INDICATORS are turning up indicating that momentum is reversing to the upside.

INTERNATIONAL STOCKS: ELEVATED

The Risk Level for **International Stocks** remains ELEVATED for developed markets but has been lowered to GUARDED for emerging markets (namely China). Both China and the US are showing clear signs their economies are recovering but unlike the US, China has made more progress in containing the virus. The pace and sustainability of the recoveries in the different countries will likely drive the earnings outlook and the relative performance of their stock markets going forward.

US HIGH QUALITY FIXED INCOME: GUARDED

The Risk Level for **US Fixed Income Quality** remains GUARDED. The Fed's unlimited Quantitative Easing (QE) is suppressing Treasury yields at the same time the personal savings rate has skyrocketed due to precautionary consumer behavior and government transfer payments. Low real yields on cash (yields after inflation) punish savers and incentivize them to spend it, which boosts the economy, or invest it, which supports the stock market. Either way, the Fed gets what it wants. Until and unless that changes, Treasuries will likely trade in a narrow range and better opportunities could lie elsewhere.

III. LOOKING AHEAD

BEAR MARKET RALLY OR NEW BULL MARKET, PART II

Last month we noted that the cyclical sectors that usually lead the market coming out of a recession—financials, industrials, energy and materials—are not doing so. We said that investors would need to see stronger performance from these economically sensitive groups to confirm the economy is truly on the mend and a new bull market is underway. Morgan Stanley Chief US Equity Strategist Mike Wilson thinks it's only a matter of time and points to improvement in key variables such as consumer confidence, manufacturing and services purchasing managers' indexes, US real gross domestic product (GDP), and inflation. "We think that the V-shaped recovery in markets foreshadows a V-shaped recovery in the economy and earnings," he says. Color us skeptical. Pro-cyclical stocks outperformed the S&P 500 from the low on March 23 to the peak on June 8 but have underperformed since then, coinciding with the upsurge in coronavirus cases. So far, the market seems unfazed by the worsening health crisis but if pro-cyclical stocks continue to underperform it would suggest that now may not be the time to be overly bullish.

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